CONTROL OF THE CAPITALIZATION OF PUBLIC SERVICE CORPORATIONS IN MASSACHUSETTS.

C. J. BULLOCK.

Control of capitalization is a highly desirable, if not an indispensable, concomitant of governmental regulation of the operation and charges of public service corporations. Legislatures or commissions may act without regard to outstanding securities, and courts may pass upon the reasonableness of such action without considering the capitalization of the corporations affected by it. But it is clear that some problems can be greatly simplified and certain difficulties wholly avoided if our legislation proceeds upon the principle of locking the door of the stable before the horse strays or is stolen.

Massachusetts was the first state to undertake systematic control of the issue of securities by public service companies, and her laws have been in force a sufficient time to afford a fair test of their wisdom and efficacy. The policy of the state has been generally approved by economists and publicists, and until recently has encountered little criticism except from representatives of public service corporations. We have had, however, very little serious investigation of the subject; while there has been a tendency to make a fetich of the "anti-stock-watering laws", and to suspect that sinister motives actuate anyone who casts doubt upon their sanctity or universal efficacy. For this reason, and in view of the fact that other states are beginning to legislate upon the subject, it seems worth while to invite attention to the policy pursued by Massachusetts.

I.

The general policy of Massachusetts has long been to require that shares in the capital stock of public service corporations shall be issued only for cash and at not less than their par value.[1] Passing over the period when such matters were governed wholly by special charters, we find that in 1852 railroads were expressly prohibited from issuing stock for less than its par value,[2] and that a few years later the same restriction was placed upon all other corporations.[3] Subsequent legislation has but strengthened this requirement by iteration and reiteration, by express prohibition of stock and scrip dividends, and by creating state commissions to supervise public service industries and enforce compliance with the law.[4]

That these statutes have never been violated in any degree, cannot be maintained; that in one devious way or another organizers of companies have sometimes managed to secure a profit not contemplated or permitted by the law, is generally believed; but it cannot be doubted that Massachusetts has in the main succeeded in confining

[1] Only manufacturing and mercantile corporations are allowed to issue shares for anything except cash, and that since 1875. Ch. 177 of 1875. Under certain conditions water and aqueduct companies may take property in payment for shares. Ch. 380 of 1894.

[2] Ch. 303 of 1852.

[3] Chs. 167 of 1858 and 104 of 1859; General Statutes (1860), ch. 68, sec. 9. In 1851 the general incorporation act for manufacturing corporations had prohibited these companies from issuing stock for less than par. Ch. 133 of 1851.

[4] The present law may be found in the Revised Laws, ch. 109, secs. 19-28, and ch. 463 of 1906. Stock and scrip dividends were expressly prohibited by chs. 310 of 1868, 389 of 1871, 372 of 1874, and 350 of 1894. The railroad commission was created in 1869, and the gas and electric light commission in 1885. Directors of gas and electric light companies and of street railways are liable for debts contracted before the capital is fully paid in. Revised Laws, ch. 110, secs. 58-63; ch. 463 of 1906, part III., sec. 29.

stock issues of public service corporations to amounts representing approximately the actual money contributed by the stockholders. It is equally certain that the general results of this policy have been wholesome, and beneficial to the companies as well as the public. The public service corporations of Massachusetts have greater stability than they would have possessed if promoters and managers had enjoyed unlimited freedom in the issue of capital stock, and their securities bear a higher reputation as safe and conservative investments. After making all allowances and qualifications, it is a fact of great significance that the average capitalization of street railways in Massachusetts in 1902 was ascertained by the census to be less than half the average capitalization of such corporations in the country at large.[5]

But though the general results have been beneficial, it seems clear that at one point the law has been too rigid. The absolute prohibition of the issue of stock at less than par makes it difficult and sometimes impossible for an unsuccessful company to rehabilitate itself. Exceptional loyalty to a corporation and faith in its future are needed to induce stockholders to subscribe at par for shares worth at the time of issue very much less than that figure. Since 1902 Massachusetts corporations have been permitted to issue preferred stock,[6] and at least one public service company that was unable to find a market for its common stock has been able to raise the capital it needed by an issue of preferred. But this is practicable only

[5] The average capitalization in the United States was $96,287 per mile of track; in Massachusetts it was $45,600. Report on Street and Electric Railways (1902), p. 51. Only states with an insignificant proportion of urban population showed a lower average than Massachusetts, while states having a similar proportion showed average capitalizations ranging from $103,267 to $177,532 per mile.

[6] Ch. 441 of 1902.

where earnings show some surplus above operating expenses and fixed charges; and, unfortunately, there are companies, particularly street railways,[7] that cannot make such a showing. In these cases, after credit is impaired, no course is open except to await consolidation with some more prosperous company.

For such mergers the law offers inducements that sometimes contrast strangely with the policy of the commonwealth at most other points. Street railways, for instance, are permitted to consolidate subject to the approval of the railroad commissioners; and the law provides merely that in the process there shall be no increase in the aggregate issues of stock and bonds.[8] The result is, ordinarily, that persons controlling a prosperous railway buy up the entire stock of an unsuccessful company, presumably at a low price. This stock is then exchanged, on a share-for-share basis, for new stock of the prosperous company, and the aggregate capitalization is not increased. The railroad commission permits this[9] because it believes that the rehabilitation of unsuccessful companies is beneficial to the public. This it undoubtedly is; and, since the law makes such undertakings difficult or impossible in any other way, the general policy of the board is to be commended, even though in particular cases the profits from such operations have been excessive. But it is evident that the issue of new stock upon the share-

[7] About half of the Massachusetts street railways, chiefly the smaller ones, are paying no dividends; and not a few are barely earning enough to cover operating expenses.

[8] Ch. 463 of 1906, part II, secs. 52 and 53. The laws governing consolidation of railroads and gas and electric lighting companies are somewhat similar, but not the same at all points. Chs. 392 of 1906 and 463, part I, sec. 67.

[9] In case of a foreclosure sale, the commission restricts the issue of new stock to an amount equal to the purchase price. Otherwise exchange takes place upon the share-for-share basis.

for-share basis amounts to nothing more than its issue for less than its par value in cash, and that the law might just as well permit the thing to be done directly as to compel it to be done by indirection. It is clear also that a statute intended to safeguard the public interest may close the front door of the stable with such violence as to force the back door wide open.

In fact, it would be better for the law to provide that a company which has reached the end of other resources should be allowed, with the approval and under the supervision of the proper commission, to raise needed capital by an issue of stock at less than par. At present the stockholders in an unsuccessful company have no practicable alternative but to sell their holdings to persons in control of some more fortunate concern, and it goes without saying that in such a forced sale they negotiate at a serious disadvantage. It is probable, also, that the present method of effecting consolidations has permitted railways earning larger profits than they considered it wise to disburse in dividends to purchase worthless lines and then distribute their surplus earnings over a larger capitalization. Finally, it should be said that such a method of distributing surplus earnings may be grossly unfair to the minority interests in the prosperous corporations. When a coterie of directors with a few of their friends purchase the stock of the bankrupt road and exchange it at par for new stock in their own company, it is evident that the earnings formerly withheld are now distributed to the few stockholders who were let into the deal, and permanently withheld from all others. One of the early consolidations brought out a protest from the minority interest, and the railroad commission did not permit the new stock to issue until an adjustment had been made that was satisfactory to all parties. Similar protection would un-

doubtedly be given by the board in any other case, but the ignorance or apathy of small stockholders has allowed certain mergers to be carried through upon terms manifestly unfair to minority interests.

II.

Naturally enough, restrictions upon indebtedness have accompanied restrictions upon the issue of capital stock. Usury laws have survived in the requirement that no corporation shall issue bonds bearing over seven per cent interest,[10] and the further restriction of gas and electric lighting companies to bonds paying not more than six per cent per annum.[11] Gas companies are expressly forbidden to issue bonds at less than their par value,[12] but the statutes do not prohibit other corporations from issuing bonds at a discount. This practice, however, is discouraged by the railroad and the gas and electric light commissions.

These commissions have control of the amount of stock and bonds that railroad, street railway, gas, and electric lighting companies can issue, and they have consistently refused to permit a company to capitalize discount on bonds. This is upon the theory that the purpose of the law is to confine the capitalization of public service corporations to the amount of money actually invested in their properties, and that discount on bonds cannot be considered money thus invested. The result is that the companies must either issue bonds at such rates of interest that bankers will purchase them at par, or issue them at less than par and in some way make good the discount. It is interesting to observe that at this point the policy of the commission is different from that followed by the New

[10] Revised Laws, ch. 73, sec. 3.

[11] Revised Laws, ch. 121, sec. 10.

[12] *Idem.*

York Public Service Commission of the Second District.[13]

Under the rulings of the Massachusetts Commission it is evident that a company would naturally prefer to issue bonds on such terms that they would sell at or about par. But this is not possible when the bonds put on the market in any year are part of a larger issue, the general terms of which have been arranged some or many years previous; nor in arranging future issues, to be sold in installments when needed, is it possible to fix a rate which will enable every installment to find purchasers at par. Accordingly Massachusetts companies sell bonds at a discount when they must. They then make up the discount out of future earnings, or else endeavor to smuggle this item into estimates of construction work, purchased property, and other things which they are allowed to capitalize. The accounts of some of the companies show that discount on bonds has been prorated over the period for which the bonds run, and money annually set aside from earnings sufficient to make up the amount at maturity. There are rumors that this item has been otherwise adjusted by some corporations.

When one considers that the actual rate of interest will be the same whether five per cent bonds are sold at par or four and one-half per cents are sold at a discount, it is hard to see why the commissions have ruled as they have. The important thing is that the companies secure the most favorable rates obtainable, and this is all that the commissions need have insisted on. Under their rulings, if bonds have to be sold at a discount the balance of the money needed for the work in hand is raised by short-time loans, and the company may actually pay a higher rate of interest on these loans than it would have

[13] See opinion hereafter quoted.

had to pay upon bonds. By this method, then, the interest charges may be increased, while the short-time loans may at any time cause embarassment to the company.

The borrowing power is further restricted by limitations upon the amount of what the law considers the permanent debt. Following a principle long embodied in the laws relating to manufacturing corporations,[14] the act of 1854, which authorized railroads to issue bonds, provided that such issues should not exceed "the capital stock actually paid in."[15] Similar restrictions were subsequently placed upon other public service corporations. Telegraph or telephone companies may not contract debts exceeding one-half of their capital stock;[16] gas and electric light companies may not isssue bonds in excess of their capital actually paid in;[17] and railroads and street railways may not issue "bonds, coupon notes, or other evidences of indebtedness payable at periods of more than twelve months from the date thereof", to an amount exceeding their paid-up capital stock.[18]

The wisdom of limiting the permanent debt to a certain proportion of the total capitalization is not open to question, and has never been the object of serious criticism. It is possible, however, that the proportion fixed for telegraph and telephone companies is too low, and may have contributed to the removal of a large telephone company from the state. Railroad and street railway companies prior to 1908 found just cause for complaint in the restriction of their bonds and coupon notes to an amount

[14] The law required that the debts of such companies should not exceed the capital stock paid in. Ch. 53 of 1829; Revised Statutes, ch. 38, sec. 25.

[15] Ch. 286 of 1854.

[16] Ch. 217 of 1851; Revised Laws, ch. 122, sec. 7.

[17] Ch. 346 of 1886, sec. 3; ch. 371 of 1890; Revised Laws, ch. 121, secs. 10 and 12.

[18] Ch. 463 of 1906, part II, sec. 48, and part III, sec. 108.

equal to the par value of their stock, whereas a considerable portion of that stock has been issued at substantial premiums. Relief was given by a recent act of the legislature[19] which authorized railroads and street railways[20] to issue bonds and coupon notes to an amount equal to the par value of their capital stock plus "all cash premiums" paid into their treasuries on shares issued in accordance with a law enacted in 1894, which will be subsequently mentioned.

A most singular fact remains to be noticed. While bonded debt has been limited very strictly, in a manner sometimes reasonable and sometimes arbitrary, practically no restrictions have been placed upon the power of public service corporations to pile up floating debt.[21] In fact, unreasonable regulations at other points have in some cases compelled them to follow this line of least resistance, even when they would have preferred to finance their undertakings in a safer and more conservative way. Railroads and street railways can borrow all the money they please, and for any purpose, provided they make their notes payable in twelve months or some shorter period; other companies, in addition to this, can issue without restriction coupon or other notes running for several years, which may be somewhat safer than obligations payable within shorter periods but are often a source of embarassment to corporations. The commissions have no power to prevent a company from borrowing money for

[19] Ch. 620 of 1908.

[20] Gas and electric light companies made no complaint since they issue few bonds and are not restricted in the issue of coupon notes as railroads and street railways are.

[21] There is a provision that any director or officer shall be liable to fine or imprisonment for voting to incur "any debt or liability except for the legitimate purposes of the corporation", but, even if intended to meet this case, it seems to have been inoperative up to the present time. Revised Laws, ch. 109, sec. 28.

the payment of dividends, or for making good the ordinary depreciation of its property; and there is reason to believe that both of these things have been done in not a few instances. Apparently the state has been watching the front door of the stable so intently that it has forgotten the very existence of the back door.

In some cases resort to the back door has been absolutely necessary on account of unwise and unreasonable restrictions upon the use of the front door. A large railroad was obliged to borrow money on its notes at eight per cent interest because it could not sell new stock at the high premium fixed by the railroad commission, and was unable to issue bonds in excess of the par value of the outstanding stock, even though part of that stock had been issued at premiums that had added many millions to the real capital of the corporation. Street railways, when beginning operations, have been obliged to issue notes running for twelve months or less, in order to raise the necessary working capital, because the commission does not permit the issue of stock or bonds for this purpose. It is not creditable to the state that public service corporations should ever be put to such shifts.

There is another class of cases in which part of the responsibility for unsound finance rests upon the managers of the companies. A corporation that has enjoyed fair credit and managed to pay dividends finds its earning power gradually or suddenly impaired. If dividends are forthwith reduced or suspended, as they should be unless the impairment is clearly seen to be due to temporary causes, the credit of the company suffers and the stock falls below par—perhaps very far below. As soon as this happens, it becomes impossible to raise capital for necessary improvements or extensions by the issue of stock, since the law provides that stock shall not go out except at par in cash; and the managers are therefore sorely

tempted to maintain dividends even though money has to be borrowed for that purpose. How often this has happened is, of course, difficult to determine; but there is reason for believing that the practice is not unknown, and it is clear that at this point the ironclad prohibition of the issue of capital stock at less than par creates a situation which encourages, if it does not compel, resort to unsound finance.

In 1907 the capital stock and funded debt of the street railways of Massachusetts amounted to $132,619,000, while the unfunded debt was $21,228,000, or nearly one-sixth of the capital stock and funded debt. That this proportion of floating indebtedness is excessive, and a matter worthy of serious consideration, will be denied by no one familiar with the conditions and prospects of the street railways of the state. The steam railroads operating in Massachusetts in 1907 reported unfunded debts that amounted to less than one-tenth of their issues of stock and bonds; while all the roads reporting to the Interstate Commerce Commission in 1906 showed "current liabilities" amounting to less than one-twelfth of their permanent capitalization. It is impossible in this paper to consider what action the state should take to improve the condition of certain street railways; but that some action must be taken before long is hardly open to question. At certain points it may be necessary to make less onerous the conditions upon which stock and bonds are issued; in some cases an increase of fares may be inevitable; but when either or both of these things are undertaken something should be done to insure thorough supervision, if not control, of the floating debts of the companies.

III.

Since 1894 the commissions have had control of the amount of securities that public service corporations can

issue for any or all purposes. Only such amounts of stock and bonds can be issued as the commissions may determine to be "reasonably necessary" for the purpose for which they are authorized; and in the case of railroads and street railways the limitation extends to "coupon notes and other evidences of indebtedness payable at periods of more than twelve months" from the date of issue.[22] Railroads and street railways must apply to the railroad commission; gas and electric light companies, to the gas and electric light commission; and telephone, telegraph, aqueduct, and water companies, to the commissioner of corporations.

To determine the amount of securities "reasonably necessary" in any case, the railroad commission is expressly empowered,[23] whenever "the public interests require" it, to "employ competent experts to investigate the character, cost, and value" of the property of any company. The commissioner of corporations and the gas and electric light commissions are apparently expected to rely upon their ordinary office force. Corporations are explicitly prohibited from applying the proceeds of stock and bonds "to any purpose not specified" in the certificate obtained from the commissions; directors, officers, and agents who knowingly issue securities in violation of the statute are liable to punishment by fine or imprisonment, or both; and the supreme judicial court is given jurisdiction in equity, upon application of the commissions, the attorney general, or any interested person, to enforce compliance with the law.

An inevitable incident of this control over the amount of a corporation's capitalization has been control over the purposes for which securities shall be issued. In the

[22] Chs. 450, 453, and 462 of 1894; 337 of 1897; 463 of 1906, part II, secs. 65-68; Revised Laws, ch. 109, secs. 24-28.

[23] Ch. 463 of 1906, sec. 1.

theory of the law the purposes for which stocks and bonds may be issued are determined by special acts or the general corporation laws; and this implies that the commissions, in passing upon applications by the companies, shall withhold their consent in any case where the securities are for a purpose not authorized by law. In any event the commissions exercise that power; and since the statutes sometimes define in very general terms[24] the purposes for which securities may issue, a great deal is left to their discretion.

Both the railroad and the gas and electric light commissions refuse to permit securities to be issued for discount on bonds. Both refuse to recognize such an item as compensation for promoters, although under the head of necessary legal and engineering expenses these crafty but indispensable persons sometimes manage to secure a "living wage". If they desire more than this they must purchase construction materials when cheap, and apply for an issue of securities when higher prices justify a higher estimate of the cost of construction work. In these and perhaps other ways it is rumored that a promoter's profit of from ten to fifteen dollars per share is sometimes secured by methods involving no excessive strain upon a conscience of average sensitiveness. The railroad commission has apparently disapproved of the issue of stocks or bonds to provide working caiptal, but the gas commission permits this item to be included in a company's original capitalization. In all of these matters there has been more or less friction between the companies and the commissions.

The issue of bonds at a discount has already received sufficient attention. The compensation of promoters is

[24] Thus street railways are authorized to increase their stock and bonds for sixteen specific objects, and "for other similarly necessary and lawful purposes". Ch. 463 of 1906, part III, sec. 103.

always a difficult question; but it seems clear that the promotion of solid enterprises is a legitimate and useful function for which reasonable compensation should be allowed, and it is better that such allowance should be made openly and directly than that it should be secured in other ways. The policy of the railroad commission in regard to working capital is not altogether easy to understand. Nothing in the statutes seems to prevent the board from ruling that materials, supplies, and a bank account are necessary for the operation of any business concern, and are, therefore, proper items to be included in its capitalization. Undoubtedly a company that has impaired its capital by paying excessive dividends should not be permitted to issue stocks and bonds to provide new working capital. Reduction of dividends rather than capitalization of deficits is the obvious remedy for such a situation, and it is possible that the policy of the board was originally adopted to meet such cases as this. But with a new company or an established company that is enlarging its business the conditions are different, and there is no justification for a refusal to include working capital in the estimate of the necessary cost of the undertaking. Upon this point, as upon the questions of promoter's compensation and the issue of bonds at a discount, a wiser and more reasonable policy has been adopted by the New York Public Service Commission of the Second District.[25]

[25] The decision of the Commission is so important that it should be quoted *in extenso:* "When the amount of the actual cost of the physical construction of the proposed road has been determined we are still far from having determined the amount of capitalization which should be allowed. There are many elements of cost attendant upon bringing into existence a new railroad additional to the cost of mere physical construction. Some of these elements may be enumerated as follows: (1) expense of organization, (2) incorporation tax, (3) expense of obtaining a certificate of public conveni-

IV.

The terms upon which a company may increase its capital stock have constituted the most troublesome problem the state has encountered in its control of the capitaliza-

ence and necessity, (4) preliminary engineering expenses, (5) expense of procuring the authorization of issue of stock and bonds, (6) expense of marketing the securities, (7) discount upon the bonds provided they cannot be sold at par, (8) interest upon the bond issue during the period of construction and prior to the beginning of operations, (9) compensation of officers of the road during the construction period, (10) incidental expenses during construction period, (11) expense of obtaining local franchises and consents.

In addition to the foregoing matters there should be provided upon the commencement of operation a fair and reasonable amount of working capital. The operation of the company can be conducted with far greater efficiency, more to the satisfaction of the public, and with better results to the stockholders, if it has at all times in its treasury a working capital sufficient and adequate to meet the requirements of the road. Experience has demonstrated this so many times that insistence upon it or elaborate demonstration of its truth is not required at this time.

Another subject of great interest and importance is the compensation, if any, to which the promoters of the enterprise should be entitled for their services. Promotion has been so extensively abused and has been so universally used as a cover for abuses in capitalization that it has come to be regarded as a term of reproach and as a device to work schemes of robbery upon the investing public. No reason is apparent why this should necessarily be so. The honest services of a capable promoter are indispensable to the flotation of every comprehensive and far-reaching scheme of development in the railroad world, or elsewhere. A clear vision to see opportunities, ability to demonstrate them to others, and energy to push to completion works untried but of great moment, are indispensable to material development and should be fairly and even liberally rewarded by the public which receives the benefit of those works. Such rewards, however, should be put upon a clear basis of business principle, should be of sufficient magnitude to encourage rather than to discourage enterprise, and should not be so great as to make an exorbitant demand which is perpetual in its nature upon the community to be served. They are to be treated simply as just payment for services performed for the corporation, which services are valuable and in many cases even indispensable. Such services

tion of public service corporations.[26] Prior to 1871 the invariable practice seems to have been to permit new shares to issue at par, whatever the market value of the outstanding stock.[27] But in 1871 a law was enacted[28] which required a railroad to offer all new shares for sale at public auction when the outstanding stock was worth more than par. The purpose of this statute was evidently to force the sale of new stock at such premiums as the status of the companies and general market conditions should enable it to command, and to abolish such things as stockholders' "rights". In 1873 the same requirement was placed upon street railway and gas companies.[29]

The wisdom of this action was vigorously assailed by the railroad commission in 1872.[30] The board pointed out that the avowed policy of the state had been to allow capital invested in railroads to obtain a profit of ten per cent,[31] if good management enabled the companies to

---

should be paid for upon the basis of what they are fairly worth, having regard to all the circumstances of the case."

Opinion of the Public Service Commission of the Second District in regard to the application of the Rochester, Corning, Elmira Traction Company, pp. 11-12.

[26] On the history of legislation concerning new stock issues see the Report of the Commission on Commerce and Industry (1908), pp. 57-60; Grosvenor Calkins, in *Quart. Jour. of Econ.*, XXII, 640-644.

[27] Until 1870 railroad issues were authorized by special acts. In that year a general law was enacted which allowed all classes of corporations to offer new shares to stockholders at par, and to sell at public auction any shares not subscribed for. Ch. 179 of 1870.

[28] Ch. 392 of 1871.

[29] Chs. 39 and 305 of 1878.

[30] Report of 1871, pp. XIX to XX.

[31] The early charters had expressly authorized profits of eight or ten per cent. The Revised Statutes of 1836 stipulated that tolls would not be reduced by the state below a figure yielding ten per cent on the capital invested. Ch. 39, sec. 83. This provision appeared

earn that amount, and showed that the new policy would reduce the return on new issues of stock to eight per cent, or even seven per cent, in the case of prosperous companies. This would be less than capital similarly invested in other states was permitted to earn, and the board raised the question whether the law of 1871 would not check railroad enterprises in Massachusetts and "divert their capital to other quarters".

Despite this criticism, the requirement that new stock be sold at auction remained in force until 1878, when it was repealed so far as railways were concerned.[32] In 1879 street railways were similarly treated,[33] but the act relating to gas companies was left unchanged. Thereafter until 1893 railroads and street railways were permitted to issue new shares to their stockholders at par; but, singularly enough, the corporations had no authority to sell stock at a higher figure except by offering it at auction. In certain cases, however, the legislature, by special acts, required a few railroads to raise additional capital by selling their stock at public auction.[34]

In 1892 the Connecticut River Railroad undertook to increase its capital stock from $2,580,000 to $5,000,000 by issuing 24,200 shares to its stockholders at par, and an act was passed by the legislature authorizing it to do so. The stock of the road was then selling at about $235, and the objection was at once raised that the proposed action amounted to declaring a stock dividend of more than $100 per share. Accordingly Governor Russell vetoed the bill which had passed the legislature, and the project was dropped. In most other states the matter would

in the General Statutes of 1860 (Ch. 63, sec. 112), but was repealed by the general railroad act of 1874 (Ch. 372 of 1874, sec. 179).

[32] Ch. 84 of 1878.

[33] Ch. 90 of 1879.

[34] See special message of Governor Russell, May 9, 1892.

probably have attracted little attention at that time. Undoubtedly the stockholders proposed to cut and divide a melon of large size and excellent flavor; but, after all, the new stock was to be paid for in cash at the par value, and the proceeds were to be devoted to necessary improvements. Elsewhere it might have sufficed that the stock was to issue at par, but in Massachusetts the project was assailed as "indirect stock watering".

Interest in the question was not abated when, early in 1893, the Connecticut River Railroad was leased to the Boston & Maine at a high rental after $1,290,000 of four per cent scrip had been distributed to the stockholders,[35] the scrip dividend exceeding by $250,000 the entire surplus of the company. The immediate results were the enactment of a law regulating future issues of stock by railroads and street railways,[36] and the appointment of a joint-special commission to devise further methods of regulation.[37] In 1894 another law[38] brought all classes of public service corporations under the restrictions imposed on railroads and street railways the previous year; while other enactments, described in earlier paragraphs, limited all future issues of stock and bonds to such amounts as the state commissions should consider necessary for the purposes for which they were authorized.

The statutes thus enacted are known popularly as the "anti-stock watering laws"; we are now concerned only with those regulating the price at which new stock may be issued. They provided[39] that when a public service

[35] The terms of the lease were criticised by the railroad commission in its Report for 1893, pp. 24-26.

[36] Ch. 315 of 1893. See special message of Governor Russell transmitting a memorial from boards of trade.

[37] For report of this commission see Sen. Doc. 67 of 1894.

[38] Ch. 472 of 1894.

[39] The law may be found in the Revised Laws, ch. 109, secs. 30 and 31; and in ch. 463 of 1906, part II, secs. 69 and 70.

corporation increased its capital stock the new shares should be offered to stockholders at a price determined by the appropriate state commission.[40] This price was to be "not less than the market value" of the shares, and in determining it the commissions were required to take "into account previous sales of stock of the corporation and other pertinent conditions". In no case, however, were shares to be issued for less than par. In case any part of an issue was not subscribed for by the stockholders at the price thus fixed, the corporation was authorized to sell such shares to the highest bidder at public auction, but at not less than the par value. And finally, in case the new issue did not exceed four per cent of the existing capital stock, the corporation was permitted to sell it at public auction without undertaking to offer it to stockholders.

The purpose of the law was clearly that new stock should be issued at its market value, either as fixed by the commissions or by sales at auction. The auction sale would evidently make stockholders' rights worth nothing; and the commissions, naturally enough, acted upon the theory that in authorizing issues to stockholders they were expected to fix prices that would accomplish the same result. The law provided that in determining prices the commissions, besides considering "previous sales of stock", should take into account "other pertinent conditions"; and thus it was possible to make allowance for the fact that a new issue of considerable size would tend to depress the price somewhat below current market quotations. The outcome was that issues were usually authorized at prices a little less than those of the last recorded sales, but only enough less to allow for the natural effects

[40] Railroads and street railways apply to the railroad commission; gas and electric light companies, to the gas and electric light commission; and other corporations, to the commissioner of corporations.

of the increase of the stock. For this the commissions were sometimes criticized, but the history of the law, as well as its plain requirement that stock should not be issued at less than its market value, seems to support the interpretation they placed upon it; and it is certain that they would have encountered more criticism, although from a different quarter, if they had followed any other policy.

If, then, a corporation wished to raise $1,000,000 by increasing its capital stock, and the commission to which it applied believed that the shares could be sold at a price of $200, permission would be granted to issue but 5000 shares. Nothing short of omniscience could have enabled the boards to comply perfectly with the intention of the statute. Sometimes they fixed prices that made stockholders' rights fairly valuable and enabled the issues to be fully subscribed, but at other times they named prices that proved prohibitive. Two issues by railroads were fully subscribed at prices of $215 and $190, but a third failed at a price of $165. No other railroads applied for issues to stockholders, the companies preferring to sell stock at auction in amounts less than four per cent of the outstanding capital, or to meet their requirements by issuing bonds. On the other hand 207 applications were made by street railways for authority to issue stock to shareholders. In 153 of these cases the shares were allowed to go out at par, since it appeared that the market value did not exceed that figure; and in 54 the stock was issued at a premium.[41] No complete data are at hand for gas and electric light companies, but it appears that stock issues were fully subscribed in some cases at the prices fixed by the commission, and that in a few instances prices were placed so high that issues were not taken by stock-

[41] See Report of Commission on Commerce and Industry, p. 66.

holders. The water and telephone companies, which fall under the jurisdiction of the commissioner of corporations, are now small concerns,[42] and no cases have yet arisen where the available data enabled him to fix a price higher than par.

The argument by which the laws of 1893 and 1894 are generally defended is that public interest demands that the shares issued when a corporation increases its stock should be confined to the number absolutely needed to raise the capital that may be required. To permit the issue of a larger number is "indirect stock watering", and imposes upon the community a heavier charge for dividends than can be justified.[43] When, therefore, the stock of a public service corporation is worth more than par, new shares should be issued only at a premium; so that the public, and not the stockholders, may reap the benefit of the high market value. When first advanced, this sounded reasonable, and the Connecticut River episode appeared a conclusive demonstration of its truth. The "anti-stock watering laws" soon became a popular fetich, and he who questioned their expediency was deemed a citizen of at least doubtful desirability. Yet experience at length showed that some modification of the law was absolutely necessary, and in 1908, upon the recommendation of a special commission, an amendatory measure was enacted.

In the first place it is beyond question that the law checked investment in railroads. Between 1893 and 1907 no new lines were constructed, only 102 miles of second, third, and fourth track were built, and construc-

[42] The larger telephone companies have left the state on account of restrictions on capitalization and some other regulations.

[43] This argument is best formulated in the special message of Governor Russell, above referred to, and the memorial accompanying the message of 1893.

tion was practically confined to the building of sidings. Some improvements were made, but it is generally agreed that the Massachusetts railroads have not kept up with the times, and now need to expend large sums of money in order to supply the facilities that the public demands. The roads finally came to the end of their resources, and some change was imperative. More than one cause may have contributed to this condition, but no small share of the responsibility falls to the law of 1893.

With street railways the case is not quite so clear. There has been since 1890 a rapid development of electric roads, but this was usually the work of new companies issuing shares at par or of old companies the stock of which did not yet command high premiums. For many years, therefore, the wisdom of forcing out stock at premiums was not put to the test; and it is only recently that difficulties have arisen. Many of the companies are now in such condition that it is not a question of selling stock at a premium but of inducing anyone to take new issues even at par, and some of the larger and more prosperous railways are facing large expenditures which they could hardly have financed under the law as it stood a year ago. In the opinion of a recent commission, the law of 1893 was not encouraging and was probably retarding the development of street railways. The situation of the gas and electric light companies is in many respects peculiar and cannot be considered in this paper.

One feature of the law which proved vicious in practical operation is the requirement that if an issue is not fully subscribed by stockholders the shares remaining unsold shall be offered at public auction. This always raises the question whether a stockholder would better subscribe for the shares when first offered at a price set by a commission, or refuse to subscribe and take the

chance of purchasing at auction at a lower figure. When an issue is only partially subscribed, the directors of a company confront a most unpleasant question. Some of the stockholders, presumably those most loyal to the company, have already purchased stock at a price apparently higher than the market value. Shall others, who preferred to await an auction sale, be given the opportunity to purchase the rest of the issue upon the more favorable terms the auction will probably establish? The injustice of such an arrangement has sometimes impressed directors so strongly that they have not tried to dispose of the shares which stockholders have left on their hands, and have borrowed money in order to meet pressing requirements.

To the auction sale there is the further objection that, if a large issue is offered, the price of the shares may be greatly depressed, while there is no possibility of guaranteeing a minimum price by having the issue underwritten. This fact alone might well discourage a company in good credit from undertaking large enterprises entailing considerable increase of capital stock. There is also the possibility that resort to an auction sale may lead to a change in the control of a corporation. This consideration may not be so weighty as the other just mentioned, but it may be sufficient to discourage large undertakings. When stockholders are given no alternative but to buy stock in their own corporation at a high premium fixed by a commission, or to go into an auction room and bid against outsiders for control of their own company, they may readily decide that it is best to leave well enough alone and seek other investments for their money. If this feature of the law had been intended to destroy the ordinary inducements to develop the business of an established corporation, it could not have been better contrived for that purpose.

Another thing fully established is that in requiring the commissions to fix the prices at which shares might be offered to stockholders the law imposed a most difficult and disagreeable duty upon the boards. Under favorable conditions expert financiers find it difficult to predict how many points the price of a security will be depressed when the issue is largely increased, and in an uncertain market accurate prediction is absolutely impossible. Yet this is the precise task which the commissions must perform, under unfavorable conditions as well as under favorable. Standing between the companies and the public, their position is difficult at best, and seldom more so than when they are obliged to determine the price at which stock may issue. If they name a figure that proves too high, they are straightway accused of incompetence; if they name one that proves too low, they may be accused of incompetence —— and perhaps something uglier if not shorter. In a rising market their task is somewhat easier, since stockholders may subscribe for shares at very high prices if there is a prospect of subsequent increase; but in a falling market nothing short of omniscience would be adequate for the task. In Massachusetts the situation is made worse by the fact that the market for most of the issues is a narrow local market, in which the prices current represent a very small volume of transactions. If on sales of ten, twenty, or fifty shares a price of $180 is established for a given stock, the cry of "stock watering" may be raised if a commission fixes $150 as the price at which twenty, thirty, or forty thousand shares may be issued. What would happen if an issue of a million shares should be asked for can only be conjectured, because corporations are "regulated" out of the state before they become large enough to ask such embarassing questions. Men who care nothing about their positions, and

less than nothing about their reputations, might perform cheerfully such a duty as the law imposed upon the commissions; others inevitably approach it with the utmost reluctance.

So much for the practical working of the law of 1893; the theoretical objections remain to be considered. The first is that for new investments involving unknown risks the law practically limited the return to a figure appropriate for investments of known value and solidity, but inadequate for any others. If a company conducting a business of known volume and character establishes its ability to pay regular dividends of six per cent, investors may purchase its shares at $150, thereby accepting an interest rate of four per cent. If the company then increases largely its capital stock in order to increase its business, an unknown risk is substituted for a known; and if the capital is needed for improvements necessary to meet new conditions but not certain to increase immediately the earning power, the risk attending the investment is very greatly increased. If the commissions were endowed with omniscience, they might take all this into account, and fix a price for new issues that would make full allowance for the risk assumed. But in practice they inevitably consider chiefly the current quotations for the outstanding stock, and make but slight allowance for "other pertinent conditions". No different result could be expected to follow from the requirement that new shares shall issue at "the market value". Under it the return on new undertakings was limited to practically four, four and one-half, or five per cent, and investment in the stock of Massachusetts corporations was seriously checked. For small additions and extensions, involving slight risk, stock could be issued in limited quantities; but it was absolutely impossible to finance large enterprises

upon an interest basis hardly exceeding the rate paid on savings bank deposits or first-rate corporation bonds.

The second objection is that the law was inconsistent with the avowed policy of the state in respect to public service corporations. Through commissions and otherwise Massachusetts has undertaken to control the charges and service of these companies, and it must be evident that forcing the issue of stock at high premiums may make such control difficult or even impossible. If a corporation is paying eight per cent dividends and the state forces it to issue new shares at a price of $200, the legislature and the commissions are thereafter estopped from reducing charges below a figure that will enable a company to pay eight per cent on its outstanding stock. By forcing the issue at $200 the state virtually creates a new par by which the reasonableness of the companies' charges should be determined. If those charges were excessive at the time of issue, they should have been reduced, and the price of the new shares should have been adjusted to a lower rate of dividend. The investor knows that the state undertakes to regulate charges, and when a commission fixes $200 as the price of a new issue, he has the right to assume that the established dividend of eight per cent is not unreasonable. The difficulty might be avoided by an express declaration that the investor has no right to assume that the commission is doing its duty under the law, and that the power is reserved to reduce dividends whenever the commission feels inclined to perform its proper functions; but this would not be likely to produce an overwhelming demand for stock at a premium of $100. In common decency, if not in law, the issue of shares at high premiums fixed by agents of the state virtually guarantees existing dividends from subsequent reduction either by the legislature or the commissions.

The legal aspects of the matter may not be so clear. Outstanding securities are not necessarily accepted by the courts as the basis for determining whether charges prescribed by legislatures or commissions are to be deemed confiscatory. But under the conditions created by the law of Massachusetts, courts might readily hold that persons who purchase stock at prices fixed by the state or its agents are entitled to at least the ordinary rate of interest, provided good management enables a company to earn it. When stock is sold at auction, and not at prices fixed by a commission, the situation is somewhat different; and the probable attitude of the courts is more difficult to predict. But the equities of the case are hardly changed, since the purpose of the auction requirement is to force the sale of shares at such premiums as the established rate of dividend will induce investors to pay; and an investor is fairly entitled to assume that the state commissions are performing their duties, and the existing charges are not considered unreasonable.

In view of these considerations and upon the recommendation of a special Commission on Commerce and Industry, the legislature in 1908 amended the law governing the issue of new stock by railroads and street railways.[44] The amendatory act provides that a company, when increasing its capital stock, shall "offer the new shares proportionately to its stockholders at such prices, not less than the par value thereof, as may be determined by its stockholders". If it had stopped here, railroads and street railways would now be able to issue new stock at par or at such higher prices as the directors might determine. But it further provides that the railroad commission "shall refuse to approve any particular issue of stock if, in the opinion of the board, the price fixed by the stockholders

[44] Ch. 636 of 1908.

is so low as to be inconsistent with the public interest." The act, finally, left unchanged the provision that issues not exceeding four per cent of the existing capital stock may be sold at auction without being offered to stockholders, and that shares offered to stockholders and not subscribed for may then be sold at auction.

The amendment was obviously intended to make the conditions imposed upon the issue of new stock somewhat more liberal to investors. The old requirement that shares must be offered to stockholders "at not less than the market value" was stricken out, and the obvious inference is that they may now issue at something less than the market value. Under the former requirement the intention of the law was that stockholders' rights should be worth nothing; under the present, the obvious intention is that they shall be worth something. How much they shall amount to will depend ultimately upon the railroad commission, which is left to wrestle with the interesting but difficult question,—What is meant by a price of issue so low as to be inconsistent with the public interest?

Upon the answer given to this question depends the success or failure of the law of 1908. The board is indeed relieved of the unpleasant duty of fixing the exact price at which stock must be offered to shareholders, and this is a decided gain; but in its power to refuse approval of new issues at prices fixed by the companies, it has power to encourage or discourage investment in Massachusetts corporations. In the cases which have thus far come before it, the board apparently has laid down the principle that the law now sanctions the issue of stock at prices that give some value to stockholders' rights, but that a price will be considered "inconsistent with the public interest" if it makes the rights more valuable than is necessary to ensure the subscription of the needed capital.

The "bearing" of this principle, as Mr. Bunsby might remark, depends on the application of it by the board to particular cases. If the commission recognizes that stockholders' rights are among the ordinary inducements that lead capitalists to invest in the stock of corporations, that the value of such rights should depend upon the risk involved in investment, and that it is more important to secure necessary facilities for the public than to confine investors to a bare return of four or five per cent, all may go well.[45] If, on the other hand, it proceeds upon the theory that capital will eagerly seek investment in the stock of corporations upon the chance of earning a maximum profit of four or five per cent, the development of transportation facilities will continue to be impeded and the unsatisfactory conditions of recent years will surely continue. In justice to the board it should be remembered that its attitude must necessarily be determined very largely by public opinion, since it is the servant of the public. In last analysis, then, the future of the transportation interests of Massachusetts depend upon the willingness of the people to allow capital invested in the stock of railroads or street railways to earn something more—and considerably more—than the savings-bank rate of interest.

V.

Public control of public service corporations is definitely established in Massachusetts, and will never be abandoned. Control of capitalization is accepted as indispensable, and has accomplished many desirable results. The require-

[45] On the day after this was written the commission decided to permit the Boston Elevated Railroad to issue 66,500 shares at a price of $110. The stock sold on that day at $129, but on sales of only 120 shares. The company is undertaking large improvements which may not increase immediately its earning power, and the commission evidently took the reasonable position that liberal terms were necessary.

ment that the securities issued by a public service company shall represent actual investment in its property has proved sound in principle and beneficial in practice. Difficulties have arisen, however, in the application of this principle, and mistakes have been made that have cost the state dear, and may cost still more dearly before they are corrected. Particular requirements of the law are arbitrary and unreasonable, a few of the policies of the commissions are open to the same criticism, and the people have sometimes shown more zeal than wisdom in the regulation of the corporations. For all of these things no small share of the responsibility rests with some of the public service companies, since the mistakes have commonly arisen from justifiable efforts to prevent the repetition or continuance of definite abuses.

In confining my study to a single state and dealing somewhat minutely with details of law and administration, I have been actuated by the conviction that attention to such details is vital to any plan of public regulation, and the thing most needed in scientific discussion of the subject. I have been influenced, too, by the further consideration that since Massachusetts has been engaged in her task longer than any other state, her experience should prove peculiarly instructive. In its general features her policy may well serve as a model, but she has made errors in detail which other states should be careful to avoid.

Of the larger questions involved the most difficult is that of the terms upon which successful corporations shall be permitted to increase their capital stock. Issue at the market price surely discourages investment and may defeat proper regulation of charges; issue at par may sometimes afford excessive gains and cause public discontent; issue under the terms of the act of 1908 may be a

satisfactory solution if the railroad commission exercises its veto power with discretion. Here, as elsewhere, the people need to consider that securing adequate service is just as important as regulating the profits of investors; and that the policy of regulation will fail just as surely if it leads to industrial stagnation as it would fail if it tolerated dishonest management and extortionate charges. For Massachusetts to fail at either point might seriously prejudice the cause of public regulation in the eyes of the entire country.